STATEMENT BEFORE THE U.S. HOUSE BUDGET COMMITTEE

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Mr. Chairman and Members of the Committee, I appreciate the opportunity to appear before you to address issues of federal spending on farm policy. I am not going to attempt to cover the whole Agriculture Budget, but instead will briefly address two central issues in commodity policy: first, assessment of the FAIR Act's "freedom to farm" approach to commodity programs as they have been implemented; and second, policy options for the immediate and longer-term future.

*Assessment of the FAIR Act*

The Agricultural Market Transition Act (AMTA) title of the 1996 FAIR Act is a novel departure in farm policy. Its fixed payments, no acreage set-asides, and avoidance CCC commodity stockpiles provides a possible means of transition to a market-based agriculture that would not require governmental intervention to prop up the agricultural economy. Some now ague that the FAIR Act has failed, on the grounds that we have spent too much, while at the same time this spending is not effectively targeted at situations and people where help is most needed. As Figure 1 shows, outlays on agricultural support are at near record highs.[1] What should be done, in the view of some critics, is to scrap the FAIR Act approach and replace it with a different approach, such as going back to payments that go up or down inversely with market prices, and annual acreage set-asides if needed to support market prices.

In order to evaluate this argument, I want to consider three important areas of federal spending on farm programs since 1996: production flexibility contract payments, marketing loan costs (principally loan deficiency payments), and crop insurance program costs. Figure 2 shows these costs, along with predecessor deficiency payment program costs, since 1992.

[1] Figure 1 shows both budget spending and payments received by farmers. The two series are closely related but differ in that some budget spending does not result in payments to producers (for example, CCC acquisitions of dairy products). The much higher budget outlays shown for FY2000 are in part the result of market loss assistance outlays for both 1999 and 2000 crops occurring in FY2000. Adjusting for this would lower the 2000 outlay value by about $5.5 billion. It should also be noted also that producers get some benefits from commodity programs apart from payments, such as higher sugar price because of U.S. import restrictions. The budget data are CCC budget outlays plus estimated crop insurance program costs as estimated by Jerry Skees, "The Bad Harvest," mimeo, University of Kentucky, 2001. CCC outlays in recent years omit USDA's personnel and other costs of administering the programs which would be about $600 million annually if included.

<u>Production flexibility, or freedom-to-farm payments</u> are the biggest item and the most troubling to many observers. As Figure 2 shows, they started at a level about equivalent to what deficiency payments had been on average in 1992-95, but have ended up higher. As contemplated at the time the 1996 Farm Bill was being debated, freedom-to-farm payments were a mechanism to phase out a long history of commodity programs for grains and cotton which had come to be seen as having outlived their usefulness. But as implemented they proved to cost more than the preceding deficiency payment programs would have cost during 1996-2000, and are no longer seen as a mechanism leading to an end to traditional commodity programs in 2002. I see the pros and cons of the FAIR Act as implemented as follows:

Pros: (1) The program has, as advertised, allowed farmers more freedom to farm, and resulted in production choices more attuned to market conditions than the old deficiency payment and set-aside approach had done. Since 1996 we have seen about 10 million acres go out of wheat and at the same time about a 12 million acre increase in soybean acreage, reflecting in part the end of restraints on incentives that the former programs had created. (2) The payments themselves have been largely non-distorting, in that whether a farmer uses more or less inputs, switches acreage among program crops, or leaves land fallow makes no difference in the amount of payments received. That is to say, the FAIR Act has generated less deadweight loss to our economy than previous agricultural programs.

Cons: (1) The payments have not been targeted to situations where they are most needed, either in terms of most depressed commodities or lowest-price years, nor have they been targeted to farmers who are most at economic risk. (2) In response to farm distress when prices fell in 1998, 1999, and 2000, market loss assistance payments were made to supplement contracted payments, but these too were not directed at states or farmers where problems were greatest. (3) The receipt of market loss assistance payments for the last three years, and their gradual expansion to cover additional crops, has led to an expectation, extending almost to a sense of entitlement, that payments at the higher levels should continue.

<u>The marketing loan program</u> was not created by the FAIR Act, but the lower prices of recent years, together with the decisions of the Executive Branch to maintain loan rates at the maximum levels the 1996 Act permitted, have made loan deficiency payments a large budget item and have caused economic distortions. With loan rates set at their legislated maximum, and the administration of the loan deficiency payment program generating expected market returns to farmers that exceed loan rates by 10 to 15%, the loan program is overriding market signals. The market mechanism is thus missing that permitted the hog prices, for example, to recover without government intervention after the extraordinarily low prices of 1998 and 1999. The exact amount by which the loan program is fostering overproduction is difficult to estimate. Reasonable estimates are those of the Economic Research Service that indicate 2000 output of grain was perhaps 2 to 3% higher than would have been the case if producers had not received loan deficiency payments. This means market prices of grains and oilseeds would have been about 3% higher, with a bigger increase for cotton, if the loan programs were not encouraging

overproduction. Consequently, of the roughly $7 billion annually the loan program is providing to farmers, $2 billion is being taken back again – actually given to consumers and others on the grain buying side of the market – through lower prices caused by the program.[2] Such distortion of markets is a real problem, and loan rates should be reduced to fix it.

Crop Insurance and Disaster Assistance Programs. Attempts to forestall the need for *ad hoc* disaster assistance by having farmers buy crop insurance are of course not new with the FAIR Act. What is new since 1996 is unprecedented levels of subsidy for crop insurance and expansions to cover economic hazards as well. The problem here is that even though the budgetary costs of crop insurance are in the neighborhood of $3 billion annually as of the 2001 programs, the programs still have not attained sufficient coverage to forestall the need for *ad hoc* disaster assistance. Moreover, the subsidies for those who participate are becoming large enough to significantly affect farmers' production decisions. In particular, there is an incentive that cannot be ignored to grow crops in more drought-prone and otherwise less favorably situated areas.

*Policy Options for the Situation in 2001 and Beyond*

What alternatives make sense to consider in formulating the Federal Budget for 2002? One tempting possibility might be to save outlays by scrapping the Freedom to Farm approach, and re-introducing acreage set-asides. The idea would be to drive up commodity prices, thereby reducing loan deficiency payments. However, acreage idling is a very wasteful use of our agricultural resources, and I believe the costs of this option to our economy far exceed the benefits.

Another option for reducing budget outlays from levels of the last two years would be simply to limit AMTA payments to the originally contracted amounts and not supplement them with market loss payments for the 2001 crops. Although commodity prices are likely to remain low this year, the idea that the U.S. farm economy is in a state of financial crisis that requires such payments is overdrawn. The best evidence of this is that cropland rental rates and prices continue to rise. It is true that some farms are in deep financial trouble. The problem with market loss assistance payments in this respect is that the vast bulk of them go to farms that are not in financial trouble, and the sums that do go to farms in financial trouble are generally not sufficient to restore them to solvency.

With respect to the longer term, the necessity to make changes in policy is greater because the FAIR Act's AMTA program expires next year. Possibilities will again be considered of returning to acreage controls, while maintaining or raising loan rates, and attempting to generate higher market prices through supply management. What are the pros and cons of this approach? The pros are that higher market prices can be obtained and thereby farm income can be supported for a smaller budget outlay. The cons are that

[2] The ERS background for the preceding estimates is in P. Westcott and M. Price "Analysis of the U.S. Marketing Loan Program," draft, August 2000; and details of the calculations are spelled out in B. Gardner, "Agricultural Policy: Pre- and Post-FAIR Act Comparisons," prepared for a Senate Agriculture Committee staff briefing, December 2000.

the cost is shifted to consumers and other buyers of commodities, and that the total costs of consumers and taxpayers together will be higher to support a given level of farm income. The total costs will be higher because farmers will have to be compensated for the costs of holding valuable acreage idle.

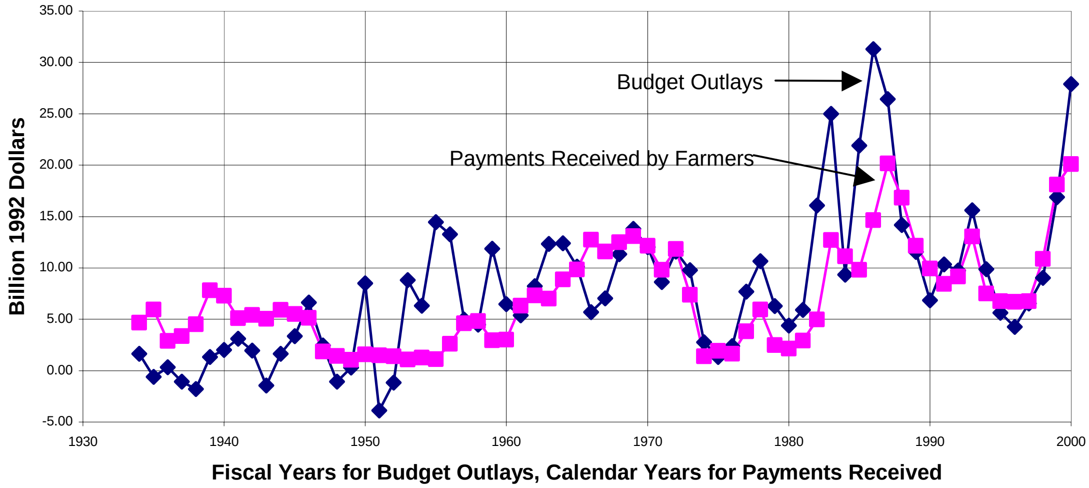
My overall estimate is that the overall sum of gains and losses under current AMTA programs for the grains and cotton is a deadweight loss of about $200 million per year. But if we tried to achieve the same level of farm income through acreage controls, the deadweight loss would be $2 to 3 billion per year.[3] Moreover, over the longer term the supply management approach becomes less and less capable of delivering benefits to farmers. I would express the basic issue as follows: we can all see that when there is a bad crop year in the United States, prices rise sharply. Demand is inelastic. There are big gains for farmers to be had. So it is natural to think that if we can create such scarcity through policy we will make our farm community better off. But the problem is that supply and demand responses in the longer run are larger ("more elastic"). If you keep managing supply year after year, and all market participants believe the U.S. will take steps to forestall lengthy periods of low prices, then foreign producers will discount the prospect of low market prices, produce more than they otherwise would (as U.S. farmers would if were not for acreage restrictions), and the main thing the United States will accomplish is to lose markets. That is the problem. That is the difficulty we got into in pre-1990 programs, and I believe it is what we will get into again if we go down the supply management route.

In short, while I would not say that the FAIR Act has been a sterling example of policy at its finest, I do say that it is an improvement over what we had before, and it would be a serious mistake to go back to former policies.

The preferable forward-looking approach in my opinion is to continue with the phase-out of payments that was begun under the FAIR Act, and to focus federal spending on policies that have reaped the greatest rewards for our nation, including food consumers as well as producers, policies which have helped make the United States the world's leader in agriculture and food production. These include continuing efforts in research, technology development, and technical education. I believe it is important to maintain these efforts, and to continue to turn these investments towards remedies for market failures, for example protecting water quality, and to keep supporting biotechnology development. It is especially important to make progress on international agreement to reduce protectionism in this and other areas of agricultural trade. A key practical step in this last area is Congressional granting of fast-track negotiating authority to the President. These policies can be supplemented with market-oriented safety net policies having only modest subsidies, and financial assistance targeted at people in trouble without locking them into losing farm enterprises – that is, broad-based rural development policies.

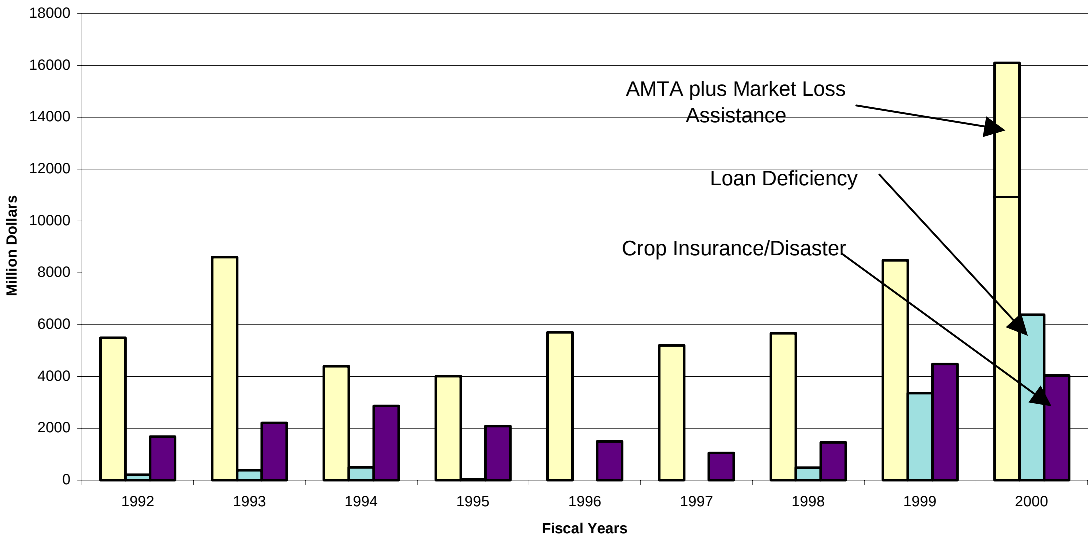
3 Details of the analysis leading to this conclusion are in "Agricultural Policy: Pre- and Post-FAIR Act Comparisons," cited in the preceding footnote.

**Figure 1. Real Farm Program Budget Outlays and Payments Received by Farmers (1992$), 1934-2000**




Source of data: USDA and Skees (cited in text).

**Figure 2. Deficiency and AMTA Payments, Loan Deficiency Payments, and Crop Insurance/Disaster Outlays**




Source: USDA and Skees (cited in text)